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The Manufacturers Hanover
Economic Report

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What Ails Us?

The U.S. economy is not afflicted with an incurable ailment. If we did suffer from a prolonged illness, it was inflation. The rate of increase in consumer prices climbed from 1.3 percent during the first half of the 1960s to 4.3 percent in the second half; 6.8 percent in the first half of the 1970s; 8.9 percent in the second half, winding up with prices rising 10.3 percent in 1981. However, most of 1981's inflation occurred early in the year: since October, consumer prices have risen at an annual rate of less than five percent. What is more, wholesale prices, which tend to lead changes in consumer prices, actually fell in February — the first monthly decline in six years. We may not have cured our inflationary malady — but we sure have eased the pain.

In spite of this breakthrough, the economy remains sick; its citizens concerned. With business failures and unemployment reaching levels not seen since the 1930s, talk of depression has begun to fill the air. We are obviously suffering from something, but what is it?

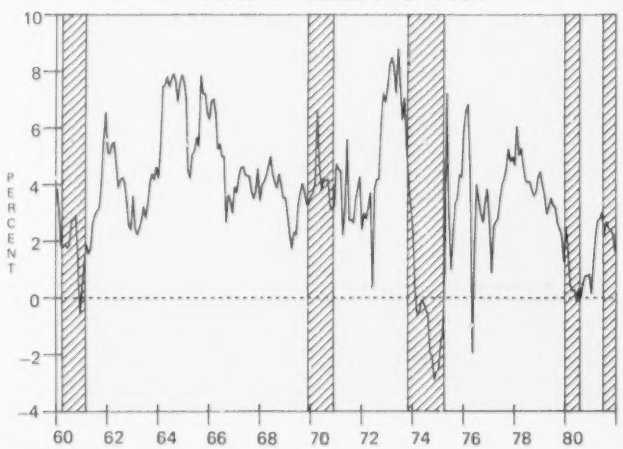
Consumers Are in Good Shape . . .

Let me tell you what is *not* causing today's ills — an overextended consumer. With the exception of two big-ticket items which I will discuss shortly, autos and housing, people's aggregate ability to purchase goods and services is about as good as it's ever been. This is vital, because consumer spending accounts for two-thirds of our economy. Let us look at the various determinants of consumer spending to see why this is the case.

A person's ability (and willingness) to spend will depend, first of all, on whether he or she has a job, then, on what that income can buy. Of course, this can be supplemented by borrowing or liquidation of existing assets, including drawdowns from savings. In terms of employment, it should be noted that, notwithstanding the large number of people out of work or even the high jobless rate, the number of people *with* jobs is up, too. In February, over 99½ million people were at work. This is only 1½ million short of the all-time record of 101 million jobholders set in May, 1981. Compared with the total population over 16, February's employment equals 57.3 percent — well above the postwar average of 55.8 percent.

Of course, those levels of employment would be only partially helpful unless the incomes they generate permitted people to buy the goods and services they wanted. Thus, it is necessary to look at buying power — what after-tax incomes will buy when inflation is factored out. While there have been times when buying power was growing faster than it is today, there have also been times when it was contracting, as you can see from Chart I. The point is — people's buying power *is* growing some two percent per annum and in the past, that was enough to produce spending gains sufficient to propel the economy forward.

CHART I
REAL DISPOSABLE INCOME
12-MONTH PERCENT CHANGE



Even more important is the fact that people can tap their credit lines, if they wished, to supplement this buying power. For a variety of reasons — recessions, reduced purchases of autos and household goods, and the aftermath of the 1980 credit controls — the percent of take-home pay required to service installment debt has fallen to one of its lowest levels in about 15 years, as you can see from Chart II. As a corollary, only 30 percent of retail sales are made today with the aid of credit; two years ago the percentage was nearly 40.

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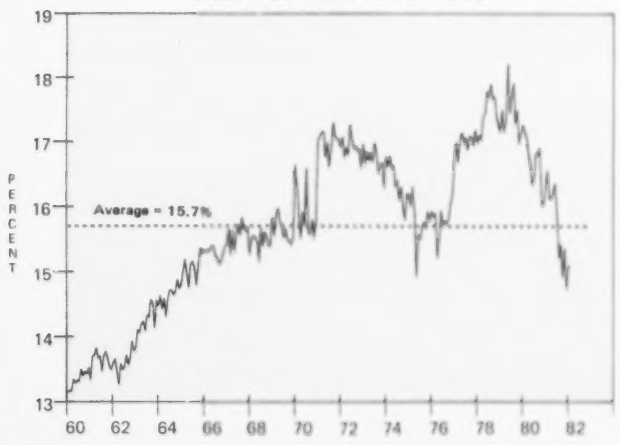
If people are leery of going into debt because of all the discouraging words they read and hear these days, they can always turn to the assets they already own. Whether you look at them in current dollars, or after adjustment for inflation, household liquid assets (defined as cash, savings accounts, money market funds and Treasury securities) are at record levels (Chart III). In particular, personal savings today total $120 billion — more than twice levels recorded as recently as five years ago!

Before going any further, I feel constrained to discuss the two major products whose accessibility appears to have moved away from consumers — autos and housing. These are the two biggest purchases the average person will ever make; they also represent the two industries whose fortunes very much affect the economy (and vice versa). Unfortunately, for reasons that predate the current recession, these two industries have been ill for quite some time — and do not appear likely to recover anytime soon.

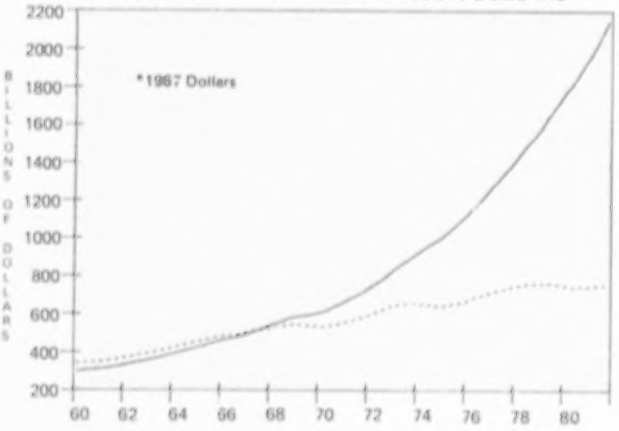
I suppose autos and housing both fell ill shortly after the 1973 oil embargo and subsequent jump in the price of energy. Both had previously grown to great economic importance because energy (gasoline, heating oil and natural gas) was plentiful and cheap. Once this ceased to be the case, it reduced the attractiveness of single-family homeownership in remote areas, far from work, shopping and schools. People began looking for houses "close in," which caused a runup in prices as "desirable" land became scarce. Meanwhile, auto-makers found they had to invest huge sums to make cars more energy efficient. The net result was that prices of both autos and housing rose sharply — faster than most other prices and most families' incomes.

CHART II
PERCENT OF DISPOSABLE INCOME NEEDED
TO SERVICE INSTALLMENT DEBT



This alone sent autos and housing into sick bay. When combined with the runup in interest rates of the past few years, their condition took a turn for the worse. In the case of housing, no recovery is likely until mortgage interest rates come down. For at today's levels of housing prices, interest rates and family incomes, some 85 percent of all households are priced out of the new-home market. By contrast only 40 percent could not afford to buy a new home in 1975 — just before housing starts embarked on a rise that saw them doubling in two years. As for autos, besides the issue of quality, price seems to be the major deterrent. Monthly payments on the average car sold in the U.S. now require 15 percent of a typical family's income to be set aside, compared with ten percent seven years ago and most of this jump traces to higher prices.

CHART III
HOUSEHOLD LIQUID ASSETS OUTSTANDING
CURRENT (LINE) AND REAL* (DOT) DOLLARS



. . . But Business is Not

The condition of these two industries might have a good deal to do with the lack of growth in industrial output over the past four years, but they don't explain the recent sudden rash of business failures and talk of depression that permeates the land. To be sure, many business casualties are related — directly or indirectly — to housing and autos. But the recent rise — as well as the general trend of the past — seems to trace to high interest rates. Chart IV shows that there appears to be a correlation between inflation-adjusted interest rates and business failures with about six months being the time when business feels their full impact. The relationship today appears to be closer than in the past because of the increased reliance on debt on the part of business.

Although in part the result of deliberate efforts to manage cash efficiently in a period of inflation and high interest rates, today's corporate debt levels have reached a point where they have become self-perpetuating. This means that what might have been desirable several years ago has now become a problem. Because of the recent uptrend in interest rates, large blocks of investment funds were channeled into fixed income obligations, causing stock prices to decline and the raising of equity capital to become impractical. As bond market rates rose into the teens, companies began to concentrate their borrowing in the short-term area, hoping to avoid locking themselves into high rates for long periods of time. And, of course, the more funds

were borrowed short, the more borrowing had to take place because the debts matured more often.

When inflation was high, business found it could afford to pay high interest rates. But once inflation receded, high interest rates became very costly (see January's Economic Report). Since they could not absorb these high real money costs, nor easily pass them on in a reduced-inflation environment, business began closing its doors at rates which soon began to compare with the 1930s. This takes us to the present, and the talk of depression.

Obviously, conditions would change for the better if real interest rates were to come down. Unless inflation flares up, this process must involve a drop in nominal rates. I observed last month that there were several reasons why interest rates have failed to come down in the face of reduced inflation and deeping recession. One was concern over the Federal Reserve's ability to manage the money supply. I regard this as a minor factor. More important is the growing borrowing needs of the Federal government, as evidenced by deficit projections that are constantly being raised upward and outward into the future as far as the eye can see. Because the Federal Reserve is no longer following a policy of replacing the funds that Washington borrows, and because the private sector's demand for funds remains strong for reasons described above, interest rates have remained high. Yet, higher interest rates in the context of reduced inflation are driving more and more companies to the brink. The status quo can't be tolerated much longer; something must be done.

Lower the Deficit . . .

From here, it would appear that the major source of today's economic woes is fiscal policy. The government's deficit is simply too large and must be brought down in a meaningful and credible way. This can be accomplished either by cutting spending across the board and/or restoring tax revenues. I use the term "restoring revenues" as opposed to "tax increase," which some Administration officials have begun using pejoratively.

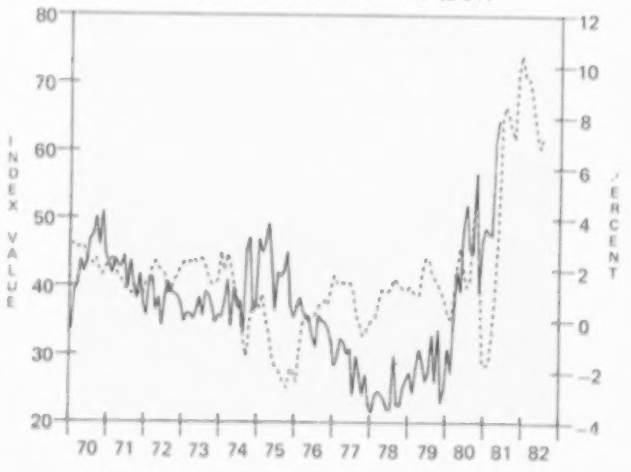
The original reason for cutting tax rates was to raise revenues enough to help finance Washington's deficit, increase defense spending, yet leave enough for business to tap in order to increase plant and equipment investment. This clearly has not worked—a fact that is admitted by the Administration in its 1983 budget document: "The Economic Recovery Tax Act (ERTA) of 1981 . . . is estimated to *reduce* (italics mine) receipts by $38.3 billion in 1982, $91.6 billion in 1983, $139 billion in 1984 and $176.7 billion in 1985."

Still committed to the tax cut, the Administration appears to have adopted a new strategy: using the current and projected budget deficits as a means of pressuring Congress to cut outlays (obviously non-defense). This may not meet with much success, either. Most citizens may be in favor of a balanced budget, but they have little enthusiasm for the cuts in Federal spending that they personally would have to endure in order to accomplish this goal. People are in favor of tightening belts — as long as it is someone else's, not theirs. So whatever cuts can be sweated out of the budget are unlikely by themselves to make more than a small dent in the deficit.

This leaves revenue restoration — an idea whose time has come. People have demonstrated in the past that they are ahead of their elected officials and today is no exception. Notwithstanding the hubris exhibited by some members of the Administration whenever talk of rescinding the tax cut arises, it is clear that the people want this — and would actually benefit as a result!

A recent survey taken by *Newsweek* bears this out. The magazine reports that 70 percent of those polled would be willing to postpone scheduled income-tax cuts in order to reduce the budget deficit. Calculations made by this Bank based on data supplied by the Congressional Budget Office (CBO), the Commerce Department plus standard mortgage payment tables reveal that whatever would be lost in the form of the foregone tax cut, would be more than made up if the result was a drop in interest rates. Remember — it is not an overextended consumer that is responsible for this recession — it is high *real* interest rates and their impact on business and consumer confidence.

CHART IV
INDEX OF BUSINESS FAILURES PER 10,000 FIRMS (LINE) VS. REAL PRIME RATE, MOVED 6 MONTHS FORWARD (DOT)



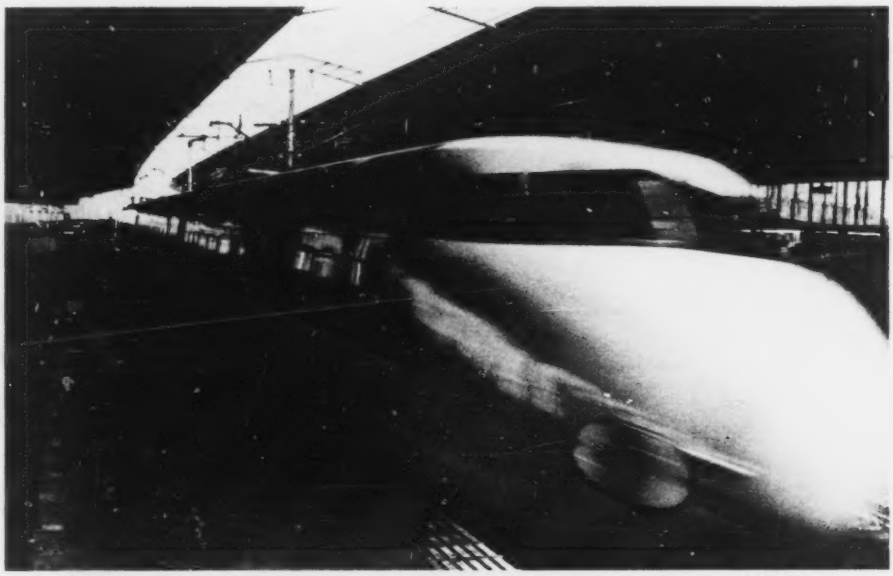
. . . And Interest Rates Will Fall

According to the Commerce Department, the median family income today is about $20,000 per year. The CBO indicates that such a family would see its tax bill reduced by $228 in 1982 under the ERTA. If rescinding the tax cut were to produce a drop of just one percentage point in mortgage rates from today's levels,

that would result in a *per-annum* saving of $483 (assuming a median priced home of $68,000, 25 percent downpayment, 25-year mortgage). In turn, this would enable nearly 23 percent of all households to afford a home, compared with only 15 percent at today's mortgage rates. A drop of four points to around 13 percent — the mortgage rate that most real estate experts feel would be low enough to trigger a revival in homebuilding with its ancillary benefits to the economy — would lower per-annum payments by $1,900 and allow one-third of all households to buy a house!

Needless to say, lower interest rates would also help bring capital spending back to life — thus permitting the Administration to fulfill its goal of revitalizing the U.S. economy. It would also help our trading partners extricate themselves from recession by enabling them to lower their interest rates without risking depreciation of their currencies with its attendant inflationary potential.

At this juncture, time is of the essence. The budget deficit must be reduced as soon as possible in a manner that is credible both statistically as well as politically. In the first instance, the reduction must be large enough to convince the financial markets that Washington's borrowing requirements will be reduced significantly over a sustained period of time. Secondly, this approach must reflect an exercise of political compromise with respect to the sacrosanct: defense, indexed entitlements and revenue restoration must all be part of the package. ■



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